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Congress of the United States
CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Kenneth Troske

Congressional Oversight Panel Hearing with Treasury Secretary Timothy Geithner

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Thank you Professor Warren.

I would like to start by thanking Treasury Secretary Geithner for appearing before us today. As the newest member of the panel I have not gotten a chance to hear you testify before and I am looking forward to hearing your thoughts about the financial crisis we have just been through and what we can expect going forward.

In my opening statement today I will focus on question I still have about why financial markets in this country have not behaved as I believe they should have if they were operating in well functioning competitive market. I have spent most of my professional life studying how markets functions, but there are several aspects about these firms, these markets, and the recent financial crisis that I find both surprising and confusing. I would not have expected to see the events that we have if the financial market was a well functioning competitive market. While I have not been closely involved in studying this sector, you, Secretary Geithner, are someone who has played a key role in dealing with this financial crisis, and have tried to understand how to prevent another similar crisis from occurring in the future. I feel that the main purpose of the Panel is to comment on the long run implications of the TARP and to comment on the effectiveness of TARP in minimizing the size of the financial crisis, and your insights are obviously valuable as we try to accomplish these goals.

One of the aspects of the financial sector I find confusing is the existence of systemically risky, or too big to fail, firms. The argument had been made repeatedly that the government needed to step in and bail out firms such as AIG or Citi because the standard bankruptcy process is slow and disruptive, and if these firms had been allowed to enter this process, it would have resulted in an enormous disruption in financial markets. Of course, U.S. bankruptcy laws have been in existence for a long time and numerous companies both large and small have entered bankruptcy in the past, so market participants should have been well aware of the difficulties large financial firms would face if they failed. Given this knowledge, as firms grew, they should have faced increasingly higher cost of capital because of the increase in the cost of potential bankruptcy risk. By imposing higher capital costs on large companies the market would have placed a limit on the size on financial firms below the too big to fail threshold. Instead, it appears as if these large financial firms faced lower costs for both debt and equity than smaller financial firms. This allowed these firms to borrow enormous sums of money, which they then used to purchase a variety of increasingly riskier assets. In an upward cycle of growth, access to cheaper capital allowed these firms to grow even larger and break the too big to fail barrier. In a well functioning market, this should not have occurred.

Another aspect of the financial crisis that I find surprising is that while the market was sending clear signals that the residential mortgage backed securities were risky, traders purchasing these assets seemed to simply ignore these signals. Basic finance theory teaches us that in order to earn an above market return one needs to purchase an asset with above average risk. This is simply a formalization of the age-old adage that economists often use, "there is no such thing as a free lunch," which in turn is a formalization of something mothers tell their children, "if something seems too good to be true, it is." Unfortunately, participants in mortgage backed securities markets ignored what they were taught in Econ 101 and what their mothers warned them about. Since these securities were earning an above market return based on the level of perceived risk, people who were purchasing them should have realized that the historical returns were not supportable, despite what they were being told by credit rating agencies. Over time, people learned that these assets were quite risky; the efficient market hypothesis worked vigorously, and many of these assets are now worth much less than what was paid for them.

By borrowing funds at relatively low rates and then investing in these risky assets, managers at financial firms were able to earn substantial bonuses and amass large fortunes. The problem appears to be that neither equity nor bond holders ever questioned the behavior of the managers of these firms. And while it may be easy to understand why equity holders were willing to play along—they were also receiving an above average return—it is much harder to understand why bond holders did not more carefully scrutinize the behavior of management since bond holders did not receive any of the return from this additional risk. In well functioning competitive markets, the role for bond holders would be to recognize that the returns the firms were receiving from the assets were greater than implied by the nature of the assets and to question the underlying characteristics and risk of the assets.

Finally, managers seemed to have done an extremely poor job assessing the riskiness of the assets they purchased, yet few managers have been penalized for their poor performance. These financial companies were essentially purchasing boxes filled with residential mortgages. These boxes were stamped on the cover by one of the rating agencies. Managers then choose some combinations of boxes to buy—some AAA boxes, a few A boxes, a couple of BB boxes—depending on the overall risk they wanted to achieve, and then they threw these boxes in the corner and just waited on the cash dividend payments produced by these boxes to arrive. It does not appear that they ever opened any of the boxes to check to see whether what was stamped on the cover was an accurate reflection of what was inside. Additionally, it does not seem that they ever tried to assess to covariance between the boxes, which is key for understanding the amount of risk faced by their firm. In other industries, managers who behaved in such a reckless fashion would find themselves out of a job. However, in the financial sector, while some managers did lose money (and a few lost quite a bit of money) many of them remain quite wealthy and continue to work in the sector. This is hard to understand.

All of this leads me to conclude that the financial sector is simply not a well functioning competitive market, and I am trying to understand why. One possibility that we need to consider is that the cause of this recent crisis is the result of how the government has dealt with past financial crises such as the failure of Continental Illinois Bank in 1984 and the more recent failure of Long Term Capital Management. In these crises, the government worked out rescue plans or bailouts that resulted in creditors always receiving 100 cents on the dollar. Given this behavior by the government, it seems reasonable that creditors began to expect that the government would always be able to work out a plan to rescue large financial firms that experience difficulties in a way that insures the creditors against losing money. As Nobel prize winning economist Joseph Stiglitz and many others have described it, we have privatized profits but socialized losses. Given this implicit insurance, creditors are incentivized to lend to large firms at low interest rates which eventually produces a firm that is too big to fail.

A large part of the problem is that in the midst of a financial crisis it is difficult, if not impossible, to suddenly change the rules of the game and begin to impose market discipline on firms. Instead, when a number of firms are struggling simultaneously, governments feel that they must step into the market and bailout the large systemically risky struggling firms or arrange mergers between some failing firms and some of the relatively healthier firms. Unfortunately, these actions produce a more concentrated and less competitive financial sector with even larger (or much too big to fail) firms. In turn, this increases the likelihood that we will suffer more, and more complicated, financial crises in the future. In the end, it should not be surprising that taxpayers have become frustrated with the fact that they are continually asked to provide very valuable insurance, at no cost to the wealthy individuals who benefit, and that this situation appears to get worse over time. To taxpayers TARP appears to be simply another taxpayer financed rescue of large financial firms that has occurred several times in the past, and their frustration with TARP seems to me to indicate that they are simply tired of insuring the losses of these firms.

Given your central role in orchestrating the government's response to the recent financial crisis, I am interested in hearing your thoughts on these issues as well as your responses to the questions the other members of this Panel have raised. Thank you again for your testimony today.